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Law Firms: Selected Partnership Tax Problems of Formation and Admission of New Partners

I. INTRODUCTION

Many of the federal income tax aspects of transactions which are common among professional partnerships, and law partnerships in particular, are not thoroughly analyzed by the taxpayers before they are effected. Often the tax ramifications are overlooked even after the transactions are completed. This comment will analyze the frequently unanticipated tax consequences which may arise from the formation of a law partnership and the admission of new partners.

Partnership tax literature is concerned primarily with capital intensive and tax shelter partnerships. Few works analyze problems peculiar to service partnerships. Law partnerships are not capital intensive as they do not depend upon capital for their income flow. The income producing elements in law partnerships are the services of the partners and their employees. As a result, the partners, upon partnership formation, upon admission of new partners, and upon withdrawal of partners from the partnership, seldom look to their specific rights in partnership capital for valuation of their interests in the partnership.

In an established, ongoing law partnership, it is not unusual that some partners would have no interest in partnership capital. This is due to the continual admission and withdrawal of the members. The partners may assume the partnership will continue and assume that the withdrawing partners simply have no interest in the library, typewriters, office furniture or other partnership capital. These assumptions may be inaccurate in the context of partnership formation transactions, however. There, the partners may all be contributing various types of capital to the partnership whereas the partnership property to which they are entitled upon liquidation or upon withdrawal from the partnership may not mirror their contributions.

Some law partnerships will adjust their interests annually. The admission or withdrawal of a partner, or the gradual shifting of

partnership interests in capital and profits may trigger tax consequences to each of the parties involved.

Throughout the following discussion it will be necessary to distinguish between the types of interests received by the partners. An important consideration in relation to the partnership formation is that the receipt of a capital interest in exchange for services is a taxable transaction.¹ However, in a law partnership, interests will generally be valued according to the partnership's income producing abilities. These abilities may have little relationship to the underlying capital or assets of the partnership given its service nature.

A carefully drafted partnership agreement is one key to the avoidance of several difficult partnership tax problems. The agreement should specify the consequences of certain transactions, the nature of the transferred interests, the partners' rights upon withdrawal, and the partners' respective rights in partnership capital and profits. This can be done prior to each of the transactions or in a general provision in the partnership agreement. The partnership agreement is authorized as a vehicle for determining the partners' interests in profits² and capital.³

In the absence of an agreement specifying the nature and extent of the partners' interests in capital and profits, those determinations are made pursuant to state law. In Nebraska, which has enacted the Uniform Partnership Act, each partner has a right to be repaid an amount equal to his or her contributions and to receive an equal share⁴ in the profits remaining after satisfaction of all liabilities.⁵ State partnership law, like the Internal Revenue Code, provides that these allocations are subject to agreements among the partners.⁶

II. FIVE TYPICAL SITUATIONS

The mechanical application of the technical rules of subchapter K to traditional methods of analyzing the tax consequences of changes in the allocation of partners' partnership interests may result in significant, adverse tax consequences to the parties. This is particularly true of changes in partners' interests in partnership capital. This comment will examine the application of the techni-

1. Treas. Reg. § 1.721-1 (1960).

2. *Id.* § 1.704-1(a) (1960) defines the partnership agreement to include any modifications with respect to a taxable year which are made subsequent to the close of the taxable year but prior to the time for filing the partnership return.

3. NEB. REV. STAT. § 67-318(a) (Reissue 1976).

4. *Id.*

5. *Id.*

6. *Id.*

cal rules of subchapter K in five typical situations and will make a recommendation pertinent to service partnerships, and to law partnerships in particular.

The five situations to be examined are: (1) the formation of a partnership by an established practitioner and a recent graduate; (2) the promotion of an associate to partner status; (3) the admission of a new partner; (4) annual shifts of partners' capital interests; and (5) the effect of the receipt of a profits interest in exchange for services. It should be also noted that although this comment does not undertake an exhaustive analysis of all conceivable law partnership transactions, it may provide hypotheticals sufficiently analogous to other transactions that their tax consequences may be derived from the following discussion.

A. Situation I: Formation of a Partnership—the Established Practitioner and the Recent Graduate

Situation I involves the formation of a law partnership between an established practitioner and a recent law school graduate. It is assumed that the established practitioner will contribute equipment, library facilities, unrealized receivables in the form of accounts receivable, and goodwill to the partnership, but will not contribute any inventory. The recent graduate will contribute cash equal to the fair market value of the property contributed by the established practitioner. Both agree to share profits and losses equally and agree that each will receive a fifty percent share of partnership capital in exchange for their equal capital contributions.

1. *Federal Tax Consequences to the Partners Upon Formation*

a. *Section 721 Nonrecognition Treatment: The Established Practitioner's Section 721 Property*

Upon formation of the partnership, the established practitioner's federal tax consequences will be determined under section 721.⁷ If the contributed items qualify as "section 721 property,"⁸ no gain or loss will be recognized on their contribu-

7. I.R.C. § 721.

8. Treas. Reg. § 1.721-1(a) (1960) specifically includes installment obligations as qualifying property under section 721. Otherwise, analogies to the section 351 corporate contribution provision have been used in determining what property qualifies for nonrecognition treatment under section 721. *Stafford v. United States*, 435 F. Supp. 1036 (M.D. Ga. 1977), *rev'd on other grounds*, 80-2 U.S.T.C. (CCH) ¶ 9218 (5th Cir. 1980).

Services contributed to the partnership do not qualify for nonrecognition

tion.⁹ Since the equipment, library facilities, and accounts receivable¹⁰ qualify as property under section 721, no gain or loss will result from their contribution to the partnership.

If some of the property contributed by the established practitioner is subject to depreciation recapture,¹¹ its contribution may trigger recapture to the extent of the amount of gain recognized pursuant to the contribution¹² or the amount which would have been recaptured upon a taxable disposition of the property at market value at the time of the contribution,¹³ whichever is less. However, no recapture will be required unless a gain is recognized on the transaction.¹⁴

The treatment of the established practitioner's goodwill will depend upon the facts and circumstances surrounding its contribution to the partnership. The Internal Revenue Service has held that it is possible for a professional to make a partial sale of goodwill in an established practice to newly admitted partners.¹⁵ Thus, if the established practitioner's goodwill is effectively transferred to the partnership, it would qualify for section 721 nonrecognition treatment.¹⁶ Nonrecognition treatment for goodwill is not certain, however. If it is in the form of books, records, files, and clientele, a

treatment under section 721. Treas. Reg. § 1.721-1(b)(1) (1960) states that "[t]o the extent that any of the partners gives up any part of his right to be repaid his contributions . . . in favor of another partner as compensation for services . . . section 721 does not apply." *Id.*

The line seems to be drawn where the services are provided for someone other than the partners and for the account or benefit of some entity other than the partnership. Thus, property, as well as rights to receive payment for services rendered may qualify as property under section 721. *United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965); *Roberts Co.*, 5 T.C. 1 (1945).

In *Frazell*, the court applied section 721 to geological maps created by Frazell's personal efforts. It disallowed section 721 treatment for the services performed by Frazell on behalf of the partnership. *See also* William A. James, 53 T.C. 63 (1969).

9. I.R.C. § 721.

10. *Roberts Co.*, 5 T.C. 1 (1945). *See* note 8 *supra*.

11. I.R.C. §§ 1245, 1250.

12. *Id.* §§ 1245(b)(3), 1250(d)(3).

13. This is the amount which would be recaptured under I.R.C. § 1245(a) absent the context of a section 721 nonrecognition transaction.

14. I.R.C. §§ 1245(b)(3), 1250(d)(3).

15. Rev. Rul. 70-45, 1970-1 C.B. 17. The ruling removes the "implication that, as a matter of law, a professional man cannot make a partial transfer of goodwill upon admission of partners to his practice." *Id.* at 18. *See Hoyt Butler*, 46 T.C. 280 (1966). In *Hoyt Butler*, there was a sale by a practicing accountant of a portion of his goodwill followed by the formation of a partnership with the purchaser of the goodwill. The court held that the sale of goodwill was valid and the seller received capital gain treatment on the transaction. *Id.* at 287.

16. 1 W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 4.02[1] n.18 (1977) [hereinafter cited as MCKEE].

problem can arise from the characterization of such items as being used by the partnership only for the duration of the established practitioner's association with the partnership. To prevent such a characterization an effective transfer of those items to the partnership is necessary.¹⁷ If the goodwill is personal to the established practitioner, *i.e.*, it is not embodied in tangible objects, he must make an effective contribution of his personal services to the partnership.¹⁸ The result seems to be that a premium is placed on thoughtful and accurate drafting in the partnership agreement and accompanying documents as they relate to the contribution of goodwill.

b. Consequences of the Recent Graduate's Cash Contribution

Assuming that the recent graduate contributes cash equal to the full value of her interest in partnership capital, she will recognize no gain or loss on the contribution.¹⁹

c. Exceptions to Section 721 Nonrecognition Treatment

Three types of transfers are excepted from the nonrecognition rule of section 721: (1) the contribution of property subject to liabilities in excess of basis,²⁰ (2) the assumption by the partnership of the contributing partner's liabilities in excess of the sum of the basis of the contributed property and the partner's share of part-

17. *Id.*

18. *Id.* On the definition of section 721 property, see generally *id.* ¶ 4.02; 1 A. WILLIS, PARTNERSHIP TAXATION 91-137 (2d ed. 1976); 2 A. WILLIS, *id.*, at 67-82.

19. Money is treated as property for purposes of section 721. See 1 MCKEE, *supra* note 16, ¶ 4.02[1].

20. Where the partnership assumes the liabilities against contributed property, the contributing partner is treated as having received a distribution of money from the partnership in the amount of the liabilities assumed by the partnership. I.R.C. § 752(b). This distribution decreases the partner's basis in his or her partnership interest under I.R.C. § 733. This distribution is taxed under I.R.C. § 731(a)(1) to the extent that the hypothetically distributed money exceeds the contributing partner's basis in his or her partnership interest. Any gain recognized would be characterized as capital in nature. *Id.*

The partner's basis in the partnership interest would include his or her allocable share of the liabilities assumed by the partnership, however. I.R.C. § 752(a) treats any increase in the partner's share of liabilities as a contribution of money by the partner. This increases the partner's basis by the amount of money contributed. I.R.C. § 722.

Thus, to the extent the partner's net liabilities (including his or her share of the partnership liabilities) are decreased, the transaction can lead to a taxable distribution. The partner's basis in his or her partnership interest would reflect only the basis of the contributed property plus the amount of liabilities attributable to his or her partnership interest. I.R.C. § 722. The excess of the amount of the distribution over the basis in the partnership interest is what I.R.C. § 731(a)(1) treats as gain on the transaction.

nership liabilities;²¹ and (3) the contribution of non-section 721 property in exchange for a partnership interest.²²

If the established practitioner contributes property subject to liabilities to the partnership or if his liabilities are assumed by the partnership, the resulting relief of his liabilities will be treated as a distribution of money to him under section 752(b) and will reduce (but not below zero) his basis in the partnership interest by the amount distributed.²³ Section 731(a)(1) treats the distribution of money in excess of the partner's basis in his partnership interest as gain from the sale or exchange of the partnership interest.²⁴

*d. Recapture of Investment Credit upon the Contribution of Section 38 Property*²⁵

Section 47²⁶ requires the recapture of investment credit taken with respect to property disposed of prior to the close of the useful life used in computing the credit.²⁷ Thus, the established practitioner's contribution of investment credit property to the new partnership might result in investment credit recapture. However, section 47(b)²⁸ allows some dispositions to escape the recapture rule if the transfer occurs "by reason of a mere change in the form of conducting the trade or business"²⁹

The regulations provide four tests for determining whether a mere change in the form of conducting a trade or business has occurred:³⁰ (1) The property must be retained as section 38 property in the same trade or business.³¹ This requirement is met since the property is still being used in the law practice. (2) The transferor

21. See note 20 *supra*.

22. Treas. Reg. § 1.721-1(b)(1) (1960). See note 8 *supra*. The relevant non-section 721 item considered herein is the contribution of services by a partner. For a discussion of this type of exchange, see notes 65-77 & accompanying text *infra*.

23. I.R.C. § 733(1). See note 20 *supra*.

24. See note 20 *supra*.

25. Property which qualifies for the credit allowed by section 38 is known as section 38 property. Except as otherwise provided in this section, the term section 38 property means property (1) with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the taxpayer, (2) which has an estimated useful life of 3 years or more (determined as of the time such property is placed in service), and (3) which is . . . (i) tangible personal property

Treas. Reg. § 1.48-1(a) (1964). Here, the established practitioner's library and equipment would probably qualify as section 38 property.

26. I.R.C. § 47.

27. *Id.* § 47(a).

28. *Id.* § 47(b).

29. *Id.*

30. Treas. Reg. § 1.47-3(f) (1967).

31. *Id.* § 1.47-3(f)(1)(ii)(a).

must retain a substantial interest in the trade or business.³² A substantial interest exists if the transferor's interest in the trade or business is "substantial in relation to the total interest of all persons"³³ It would seem that the established practitioner meets this test since his interest in the partnership is as substantial as anyone's, assuming an equal split of profits and capital between the two partners.³⁴ (3) Substantially all the section 38 and non-section 38 property necessary to operate the trade or business must be transferred to the partnership.³⁵ The established practitioner meets this requirement assuming his entire practice is contributed to the partnership. (4) The partnership's basis in the section 38 property must be determined in whole or part by the established practitioner's basis in the property prior to the transfer.³⁶ Since section 723³⁷ provides that the partnership's basis in contributed property is determined with reference to established practitioner's pre-transfer basis, this requirement is also fulfilled.

Under the facts set forth in Situation I, the established practitioner is not required to recapture investment credit taken with respect to section 38 property contributed to the partnership.

32. *Id.* § 1.47-3(f)(1)(ii)(b).

33. *Id.* § 1.47-3(f)(2)(i).

34. *Id.* § 1.47-3(f)(6), *Example* (5) (1967) confirms this interpretation of the hypothetical facts in regard to whether the established practitioner has retained a substantial interest in the trade or business. *Id.* *Example* (1) indicates the same result for the retention of as little as 45% of the previous interest.

James Soares, 50 T.C. 909 (1968) would seem to indicate a certain lower limit for the percentage of the prior interest which must be retained. In *Soares*, the taxpayer had transferred section 38 property to a partnership in exchange for a 48% interest. Thus, he retained a 48% interest. However, later in the same taxable year, the taxpayer transferred his 48% partnership interest to a corporation in exchange for a 7.22% interest in the corporation. *Id.* at 910. The Tax Court held that in the exchange of the 48% partnership interest for a 7.22% interest in the corporation, "petitioner did not merely change his form of conducting his trade or business, and therefore his disposition of the section 38 property qualifies for the recapture of the investment credit under section 47(a)(1)." *Id.* at 914. Additionally, the court stated:

To us, the phrase "substantial in relation to the total interest of all persons" means that after the petitioner transferred his trade or business to the corporation, he must own a significant portion of all of the outstanding stock in order to qualify under this regulation. (Emphasis supplied.) In the instant case, the stipulated facts show that petitioner, after acquiring the stock of the corporation, only held approximately 1 out of 14 shares of the outstanding stock. We believe this small fractional portion of the total shares fails to satisfy the test in the regulations.

Id. at 913. See also 2 A. WILLIS, *supra* note 18, § 69.06.

35. Treas. Reg. § 1.47-3(f)(1)(ii)(c) (1967).

36. *Id.* § 1.47-3(f)(1)(ii)(d).

37. I.R.C. § 723. See generally 1 MCKEE, *supra* note 16, ¶ 4.05[3]; 2 A. WILLIS, *supra* note 18, § 69.06.

Moreover, since the recent graduate has not disposed of any section 38 property (having contributed only cash) there is no risk of investment credit recapture.

e. The Partners' Bases in their Partnership Interests

Section 722³⁸ provides that a partner's basis in his or her partnership interest is the sum of (1) the money contributed to the partnership, (2) the adjusted basis of the property contributed, and (3) any gain recognized in the transaction. Thus, the established practitioner would have a substituted basis in his partnership interest equal to the sum of (1) the cash contributed, (2) the adjusted bases of equipment, library and office furniture, goodwill, and accounts receivable,³⁹ and (3) any gain recognized on the contribution. Note that under section 752(a),⁴⁰ a partner's share of partnership liabilities increases the adjusted basis of his or her partnership interest.⁴¹ Thus, if the partnership assumes the accounts payable of the established practitioner, or assumes liabilities on property contributed by him, the recent graduate's allocable share of those liabilities will increase the adjusted basis of her partnership interest. The assumption of those liabilities will also reduce the adjusted basis of the established practitioner's partnership interest.⁴² The assumption of partnership liabilities by the recent graduate is treated as a contribution of money by her.⁴³

The recent graduate's basis in her partnership interest would equal the sum of (1) the money contributed by her, and (2) as stated above, her share of the partnership liabilities.⁴⁴ The regulations provide that partners in a general partnership are considered to share liabilities in the same ratio that they share partnership losses;⁴⁵ which in turn may be determined by the partnership agreement.⁴⁶ Since the partners in Situation I share capital, profits, and losses equally, 50% of the partnership liabilities will be attributed to each of them for purposes of determining the adjusted bases of their partnership interests.

38. I.R.C. § 722.

39. Accounts receivable would have a zero basis under the cash basis accounting method.

40. I.R.C. § 752(a).

41. *Id.* § 733(1) is the provision which accomplished the basis reduction. Section 752(a) characterizes the relief of liabilities as a distribution of money subject to section 733(1).

42. See notes 23-24 & accompanying text *supra*.

43. I.R.C. § 752(a).

44. *Id.* § 722.

45. Treas. Reg. § 1.752-1(e) (1960).

46. *Id.*

f. The Partners' Holding Periods for Partnership Interests

The established practitioner's holding period is determined under section 1223(1), which provides that the holding period of a partnership interest includes the period for which the contributed property was held prior to the exchange:

if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and . . . the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231.⁴⁷

The established practitioner's basis in his partnership interest is the same, in whole or in part, as his basis in the property exchanged for it. Thus, the holding period for his partnership interest will include the period for which he held the property if such property was, at the time of the exchange, either a capital asset under section 1221 or a section 1231 asset.⁴⁸ A partner's holding period begins on the date of acquisition of a partnership interest when property which is neither a section 1221 or a section 1231 asset is contributed to a partnership.⁴⁹

The consequences of a contribution of both qualifying and non-qualifying property under section 1223 are uncertain.⁵⁰ The treatment of analogous situations indicates that the holding period of the interest may include the holding period of the contributed

47. I.R.C. § 1223(1).

48. *Id.*

49. Treas. Reg. § 1.1223-1(a) (1960).

50. The question seems to be whether the contribution of non-capital or non-1231 property taints the tacking of the holding period of the capital or section 1231 assets, and requires fragmentation of the partnership interest according to the different holding periods of contributed property. Rev. Rul. 68-79, 1968-1 C.B. 310 holds as follows:

D should take into account separately in his return, as long-term capital gain, his distributive share of the partnership's long-term capital gain arising from the sale by the partnership of X corporation stock held by it as an investment for more than six months, notwithstanding that D has a holding period for his partnership interest of not more than six months.

Id.

Likewise, in *Allan S. Lehman*, 7 T.C. 1088 (1946), *aff'd*, 165 F.2d 383 (2d Cir. 1948), the court rejected the Commissioner's argument that it is the holding period of the partnership assets which determines the long or short term character of the gain recognized by a partner upon a sale of a portion of his partnership interest. There, the size of the partner's interest had fluctuated widely over a period of nearly ten years, but had never been smaller than the size of the portion of the interest which was sold. On those facts, the court indicated that even if fragmentation were proper, the partner had done as well as could be expected to identify the disposed interest as one which had been held for more than ten years. 7 T.C. at 1100. See also 1 MCKEE, *supra* note 16, ¶ 4.01[2][a]; 1 A. WILLIS, *supra* note 18, § 13.05.

qualifying property so long as the adjusted basis of the partnership interest is determined *in part* by reference to the adjusted basis of contributed section 1221 or 1231 property in the hands of the contributing partner.⁵¹ Thus, the holding period for the established practitioner's partnership interest may include the holding period of the goodwill and the equipment and library facilities he contributed. However, this result is not certain since he is also contributing accounts receivable which are neither capital assets nor section 1231 property.⁵²

The holding period of the recent graduate's partnership interest would begin on the date of its acquisition since she is contributing cash, which does not qualify under section 1223.⁵³

2. *Federal Tax Consequences to the Newly Formed Partnership*

Under section 721, the newly formed partnership will recognize no gain or loss in the facts set forth in Situation I. The property contributed by the established practitioner qualifies for section 721 nonrecognition treatment as does the cash contributed by the recent graduate.⁵⁴

The partnership's adjusted basis in the property contributed to it is determined under section 723.⁵⁵ It equals the sum of (1) the adjusted bases of the contributed property in the partners' hands at the time of its contribution, and (2) any gain recognized by the partners as a result of the transaction. Thus, the partnership in Situation I takes a carryover basis in the equipment, library facilities, goodwill, and unrealized receivables and a full basis in the cash.

It is relatively certain that the partnership's holding period for the property contributed by the established practitioner will include the period for which it was held by him⁵⁶ since the partnership basis is determined, in whole or part, by reference to the basis of the property in his hands.⁵⁷

51. See note 50 *supra*.

52. See I.R.C. §§ 1221(4), 1231(b).

53. *Id.* Section 1223 requires that the contributed property be either a section 1221 or 1231 asset in order for the partnership interest to include the holding period of the contributed assets.

54. See notes 9, 14-16, 19 & accompanying text *supra*.

55. I.R.C. § 723.

56. Treas. Reg. § 1.723-1 (1960) states this result, however the operative provision is I.R.C. § 1223(2).

57. I.R.C. § 723.

3. Admission of a New Partner

Assume that the partnership in Situation I later decides to admit a new partner in order to upgrade its tax practice. She will receive a one-third interest in partnership capital and profits and will contribute cash equal to the fair market value of her one-third interest in partnership capital. This situation should not change the tax consequences analyzed with respect to the formation of a new partnership,⁵⁸ and it illustrates one difference between section 721 and its counterpart in the area of corporate taxation, section 351.⁵⁹

B. Situation II: Promotion of Associate to Full Partner—Full Capital and Profits Interest in Exchange for Property and Services

Situation II assumes the existence of a two-person partnership and analyzes the consequences of the promotion of an associate to partner status. It assumes that the associate will receive an equal one-third interest in partnership capital and in profits generated after the promotion. The associate will contribute cash equal to the value of the interest she will receive in partnership cash upon her promotion plus 15% of the fair market value of her interest in noncash partnership capital measured by the value of the underlying noncash assets.

1. Recognition of Gain or Loss by the New Partner

The characterization, for tax purposes, of the gain recognized by an associate upon her promotion to partner becomes problematic when the fair market value of the capital interest received by her exceeds the fair market value of the property contributed by her. If that excess value is characterized as compensation for past or future services, then it may be taxable, upon receipt, as ordinary income.⁶⁰ Yet, the associate will exchange *some* property (cash) for her partnership interest which should qualify for nonrecognition treatment under section 721.

58. See notes 109-112 *infra* for a discussion of the investment credit recapture consequences upon admission of new partners. See also Comment, *Investment Credit and Recapture in Partnership Transactions*, 59 N.B. L. REV. 113 (1980).

59. The contribution of property to a corporation in which two shareholders already hold equal interests, in exchange for a one-third interest in the corporation would not qualify for nonrecognition treatment due to the "80% control" requirement of section 351(a). I.R.C. § 351(a). The control requirement is set out in *id.* § 368(c).

60. "To the extent that any of the partners gives up any part of right to be repaid his contributions . . . in favor of another partner as compensation for services . . . , section 721 does not apply." Treas. Reg. § 1.721-1(b)(1) (1960). Thus, the transaction would not receive nonrecognition treatment.

a. *Capital Interest Received as Compensation for Services*

The receipt of property given as an inducement to enter into an employment agreement has been held to be taxable as compensation to the recipient.⁶¹ Moreover, bargain sales of stock to persons who have performed or will perform services for a corporation have been held to be compensation to the extent that the fair market value of the stock exceeds the amount paid by the transferee.⁶² The courts have taxed such compensation even where the gain would otherwise have been nontaxable under the nonrecognition provisions relating to corporate reorganizations.⁶³

Conversely, if the purchaser is ignorant of any bargain element in the transaction, the amount by which the value of the property received exceeds the consideration given may not be characterized as compensation.⁶⁴

61. *Stuart L. Baltimore*, 58 T.C.M. (P-H) ¶ 58,078 (1958).

Petitioner left a position paying him a total remuneration of \$175 per week, to operate Supreme at a salary of \$125 per week. He also received, as part of the same transaction, an equal share in the enterprise. He does not deny that his salary is income, and we do not understand how the receipt of a share in the business stands on a different footing. One item, as much as the other, was received by petitioner in return for leaving his previous employment and operating Supreme.

Id. at 336. The taxpayer in *Baltimore* was not bound to remain in the employ of Supreme. However, the court stated that "[a]n excludable gift within the indentment [*sic*] of the statute requires a donative intent. . . . The presence of consideration, however, is inconsistent with such intent and is fatal to the applicability of that provision." *Id.* The court considered the absence of an employee status of no significance and stated that the determinative factor was that "[p]etitioner received an interest in Supreme . . . in return for doing something desired by the investors." *Id.* The circumstances clearly negated any donative intent.

62. *William H. Husted*, 47 T.C. 664 (1967). In *Husted*, the court examined a purchase of corporate stock in a corporate reorganization setting. The court first determined that Husted had in fact purchased the stock for less than its fair market value. *Id.* at 674-75. The court then noted that since 4,200 shares of the bargain stock had been sold to Husted subject to a repurchase agreement contingent on the completion of the corporate merger, the stock was compensation to Husted. *Id.* at 675.

The court then held that the shares received in exchange for Husted's Dorsey-Delaware stock was a bargain purchase without donative intent and was actually compensation for Husted's services in arranging and masterminding the merger and acquisition. *Id.* at 676-77. Thus, I.R.C. § 356(f) was applicable and the gain was taxable as compensation to Husted. *Id.* at 677.

63. *Id.*

64. *Oliver R. Aspegren, Jr.*, 51 T.C. 945 (1969), *acq.*, 1969-2 C.B. xxiii, *acq. withdrawn and nonacq. entered*, 1973-2 C.B. 4.

b. Recognition of Compensation Income by the Associate

Based on existing authority, it is unlikely that the associate would be afforded nonrecognition treatment to the extent that the value of her capital interest exceeds the value of the property she contributes. That amount will probably be treated as compensation for services since there is an existing employer-employee relationship. Additionally, even where the incoming partner is not an associate, the situation could be characterized as the receipt of a partnership capital interest as an inducement to work for the firm.

If the newly admitted partner is not an employee of the partnership, the question also arises whether the interest is received in exchange for services. Such an exchange can be characterized as the receipt of a capital interest in exchange for future services; a characterization sufficient to trigger immediate tax consequences to the associate and to the partnership.⁶⁵

The rationale of the cases discussing employer-employee relationships and inducement lends support to the propriety of characterizing at least a portion of the amount received by the new partner in excess of the amount contributed as compensation for services. If the characterization is proper, the next question is how to treat the taxable portion of the transaction.

In *United States v. Frazell*,⁶⁶ the court allowed nonrecognition treatment for that portion of the fair market value of the partnership capital interest Frazell received in exchange for the geological maps he had developed and contributed to the partnership.⁶⁷ The receipt of the remainder of the partnership capital interest was taxed separately, as compensation for services rendered in developing the maps.⁶⁸

In *Stafford v. United States*,⁶⁹ the court held that a thirty-year

65. See notes 61-62 *supra*.

66. 335 F.2d 487 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965).

67. 335 F.2d at 490. The court indicated that this treatment was proper under section 721 as well as under section 351(a). *Id.*

68. *Id.*

69. *Stafford v. United States*, 435 F. Supp. 1036 (D.C. Ga. 1977), *rev'd on other grounds*, 80-1 U.S.T.C. (CCH) ¶ 9218 (5th Cir. 1980). Although the basis for the court's decision was the existence of material factual disputes which rendered the district court's disposition of the case on motion for summary judgment inappropriate under Rule 56 of the Federal Rules of Civil Procedure, the court stated its inclinations regarding the question of whether the lease commitment and loan commitment actually qualified as property under I.R.C. § 721:

While the letter of intent may, under these circumstances, have had value to the limited partners, it is not at all clear whether that fact would imbue the letter of intent with the status of property within the meaning of § 721. . . . Contrary to the opinion of the district court, we think that enforceability of any agreement evidenced by a

ground lease commitment and a five million dollar first mortgage commitment at a six percent interest rate qualified as property and were therefore entitled to nonrecognition treatment under section 721.⁷⁰

The court concludes that the lease and loan agreement at rates substantially below existing market levels which Stafford assigned to the partnership in exchange for a partnership interest constituted property within the meaning of Section 721 of the Internal Revenue Code in connection with which no gain or loss was recognizable.⁷¹

While the court did not attach a specific monetary value to the contributed commitments, it twice noted the fact that they did have value.

Clearly, the assigned items had considerable value. The lease itself was highly economic, and interest rates had been rising and had even reached 9% percent by the time the loan was actually closed. Thus the agreement to lend Five Million Dollars for thirty years at 6% percent interest, alone, had a substantial value.⁷²

The court in *Stafford* found value in the contributed commitments even though there was substantial doubt as to their enforceability. The court's view was that

whether the agreement was or was not legally enforceable is immaterial. The record is clear that LOG [Life Insurance Company of Georgia] and Stafford had a meeting of the minds, they entered into an agreement, they each felt that they were bound by the agreement, and they ultimately performed according to its terms.⁷³

Other important factors were present in the *Stafford* decision, however: (1) Stafford had no principal for whom he acted in securing the commitments; (2) the investors in the limited partnership which was formed were solicited *after* the LOG-Stafford negotiations and agreements; (3) Stafford received a salary in connection with his later management of the partnership and construction of the hotel facility; and (4) there were no restrictions on the receipt of his limited partnership interest.⁷⁴

The effect of *Stafford* on *Frazell* is unclear; however, it appears that courts will examine the relative values of the exchanged

letter of intent, while perhaps not dispositive of the question, is important and material to the question of whether Stafford transferred property to the partnership under § 721.

80-2 U.S.T.C. (CCH) ¶ 9218, at 83,355 n.6 (citations omitted). The opinion does suggest that the district court's utilization of a bifurcated approach in determining the appropriate tax treatment of the receipt of the capital interest in *Frazell* was correct. *Id.* at 83,353 n.5.

70. 435 F. Supp. at 1039.

71. *Id.* at 1039.

72. *Id.* at 1038.

73. *Id.* at 1039. It is this portion of the district court's reasoning that the Court of Appeals takes exception to. 80-2 U.S.T.C. (CCH) ¶ 9218, at 83,355 n.6.

74. *Id.* at 1038.

properties using a pragmatic analysis in order to determine whether a partnership interest has been received as compensation for services. The problem lurking in the *Frazell* decision is how to measure the portion of the value of the capital interest attributable to the employee-recipient's performance of services. In *Frazell*, the court determined that "[s]uch part of the \$91,000.00 as exceeds the value of the maps as determined by the trial court is properly taxable to Frazell as ordinary income."⁷⁵ However, this value was to be measured at the time that the maps were contributed by Frazell.⁷⁶

It is probable that when an associate is promoted to partner status and receives a capital interest, the Service will characterize the transaction as the receipt of compensation for services rendered even though some cash will be contributed and even though the associate had received a salary prior to the promotion. Given the disparity between the value of the interest and the amount paid for it, and the close tie to past services performed by the associate, her receipt of the capital interest will almost certainly be characterized as compensation taxable under section 61.⁷⁷

2. The Frazell Approach—Bifurcation of the Transaction

a. Consequences to the Associate

Bifurcating the transaction in Situation II requires two separate analyses. First, the cash portion of the transaction, which qualifies for section 721 nonrecognition treatment, would receive the same treatment as the recent graduate's acquisition of an interest in Situation I.⁷⁸

To the extent that the value of the partnership capital interest exceeds this value of the property exchanged for it, the rationale and tests adopted in *Frazell* are applied in taxing the transaction. The amount of that excess is treated as compensation⁷⁹ regardless of whether it is compensation for past or future services.⁸⁰ The

75. *United States v. Frazell*, 335 F.2d 487, 491 (5th Cir. 1964) (footnote omitted), *cert. denied*, 380 U.S. 961 (1965).

76. *Frazell v. United States*, 269 F. Supp. 885, 887 (W.D. La. 1967). On remand, the district court found the value of the maps to have been \$25,000.00 at the time of contribution. *Id.* at 890. The Commissioner conceded that Frazell had actually contributed the maps to the business. *Id.* at 886-87.

77. I.R.C. § 61. The court's decision in *Frazell* to split the interest and the district court's examination in *Stafford* of the disparity between the fair market value of the partnership interest and the fair market value of the contributed property support this conclusion. See generally 1 MCKEE, *supra* note 16, ¶ 5.02[1].

78. See note 19 *supra*.

79. *United States v. Frazell*, 335 F.2d 487, 490-91 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965).

80. See notes 61-62 & accompanying text *supra*.

amount treated as compensation would be taxed as ordinary income⁸¹ under section 61(a).⁸² The associate's basis in her interest would be increased by the amount of gain recognized.⁸³ The rest of the consequences would be similar to those set out in Situation I with respect to the associate's holding period for her partnership interest and the partnership's holding period for the contributed property.⁸⁴

b. Consequences to the Partnership

The consequences to the partnership of employing the bifurcation analysis in Situation II will depend upon the characterization of the capital interest for services exchange. Two possible characterizations are discussed below: (1) the Two-Step Analysis and (2) the One-Step Entity Approach.⁸⁵

(1) The Two-Step Analysis

If the transaction in Situation II is bifurcated and a portion is taxable as compensation income,⁸⁶ the regulations characterize the exchange of the capital interest for services as a guaranteed payment.⁸⁷ Under section 707(c)⁸⁸ the guaranteed payment will be deductible by the partnership if the requirements of section 162(a) are met.⁸⁹

The method of computing the gain to be recognized by the partnership in Situation II, and the character of that gain, is uncertain.⁹⁰ Apparently, a two-step analysis may be used to resolve these questions in the partnership formation stage.⁹¹ First, the

81. I.R.C. § 64.

82. *Id.* § 61(a); Treas. Reg. § 1.721-1(b)(1) (1960).

83. The associate's basis in her partnership interest would be the sum of (1) the basis of the section 721 property contributed by her; (2) the amount of liabilities she assumed upon her promotion to partner; and (3) the amount of gain recognized by her under section 61 upon receipt of the interest. I.R.C. §§ 722, 752(a).

84. See notes 53, 56 & accompanying text *supra*.

85. These two analyses are discussed at length in 1 McKEE, *supra* note 16, ¶ 5.03[1][c].

86. See notes 91-102 & accompanying text *infra*.

87. Treas. Reg. § 1.721-1(b)(2)(i) (1960).

88. I.R.C. § 707(c).

89. *Id.* § 162(a); Treas. Reg. § 1.707-1(c) (1960). Additionally, if partnership liabilities are assumed by the associate upon her promotion, the existing partners are treated as having received distributions of money to the extent their shares of partnership liabilities are decreased. See I.R.C. §§ 752(b), 731(a). See also note 20 & accompanying text *supra*.

90. 1 McKEE, *supra* note 16, ¶ 5.03[1][c].

91. F.C. McDougal, 62 T.C. 720 (1974). See also 1 McKEE, *supra* note 16, ¶ 5.03[1][c].

partnership would be treated as having conveyed an undivided interest in the existing partnership property to the associate⁹² in a transaction which would be treated as a taxable exchange of services for property.⁹³ Second, upon the associate's receipt of the undivided interest in partnership property, she would be treated as having recontributed it to the partnership in a tax-free section 721 transaction.⁹⁴

This two-step approach was applied by the Tax Court in *F.C. McDougal*.⁹⁵ The formation of a partnership was the subject of the *McDougal* case, but the two-step analysis seems equally appropriate where a new partner is admitted to an existing partnership,⁹⁶ as in Situation II.

The application of the first step of this analysis would yield the following results to the partnership. Since the transfer would be viewed as a taxable exchange of an undivided interest in partnership property for services, the character of the partnership's gain would be determined by reference to the character and holding period of the property hypothetically conveyed to the associate.⁹⁷ The gain recognized would be the amount by which the fair market value of the transferred property exceeded the partnership's basis in that property.⁹⁸ Because she recognizes gain, the associate would receive a cost basis in the hypothetically conveyed property.⁹⁹ Upon recontribution of the property to the partnership in

92. *F.C. McDougal*, 62 T.C. 720, 725 (1974).

93. *Id.* at 726. See also Treas. Reg. § 1.721-1(b)(1) (1960).

94. *F.C. McDougal*, 62 T.C. 720, 725 (1974).

95. 62 T.C. 720 (1974).

96. See 1 McKEE, *supra* note 16, ¶ 5.03[1][c] ("While this two-step approach to the taxation of capital interest transfers may seem highly fictionalized, it produces sound tax results, similar to those that occur under general tax principles when property is conveyed in payment for services.").

97. *F.C. McDougal*, 62 T.C. 720, 727.

As the McDougals were in the business of racing horses, any gain recognized by them on the exchange of Iron Card in satisfaction of a debt would be characterized under section 1231(a) provided he had been held by them for the period requisite under section 1231(b) as it applies to livestock acquired before 1970.

Id. (footnote omitted).

98. Treas. Reg. § 1.721-1(b)(1) (1960) states that section 721 would not apply to an exchange of partnership capital for services. See also *F.C. McDougal*, 62 T.C. 720, 726 (1974). In *McDougal*, the taxpayer had exchanged a one-half interest in a race horse in fulfillment of an obligation which had arisen from the performances of services in connection with the care and training of the horse. He was required to recognize gain on the exchange to the extent that the value of the services exceeded the taxpayer's adjusted basis in one-half interest in the horse. *Id.* Valuation of the fair market value of the transferred interest in capital should be determined by a valuation of the underlying assets. *Id.* See generally 1 McKEE, *supra* note 16, ¶ 5.03.

99. I.R.C. § 1012.

exchange for a capital interest in a nontaxable section 721 transaction, the partnership's basis in the assets would be increased to reflect the associate's newly acquired basis in them.¹⁰⁰ This treatment would equalize the associate's basis in her partnership interest (which would equal the amount of gain realized in the hypothetical section 707(c) guaranteed payment¹⁰¹) with the partnership's basis in the hypothetically recontributed assets.¹⁰²

Another possible result of using the two-step analysis is that recapture provisions may apply if there is a taxable exchange of recapture property for services.¹⁰³ Thus, gain that may otherwise be characterized as capital gain to the partnership in the first of the two steps could be recharacterized as ordinary income by treating the transaction as an exchange of an undivided interest in the partnership property for services.¹⁰⁴

(2) *The One-Step Entity Approach*

If the taxable portion of the transaction is treated as an exchange of a partnership interest for services (as opposed to a conveyance of an undivided interest in the partnership assets) there would be no increase in the partnership's basis in its assets.¹⁰⁵ This would be analogous to the issuance of corporate stock in exchange for services in that there would be no hypothetical distribution of assets. Under section 1032,¹⁰⁶ a corporation is not required to recognize gain when it issues stock in exchange for services,¹⁰⁷ but this provision does not control partnership transactions. The partnership could not increase its basis in partnership property since there would be no hypothetical recontribution of property with a stepped-up basis to the partnership. The partnership would still receive the deduction for the guaranteed payment to the partner, however.¹⁰⁸

100. *Id.* § 723.

101. *Id.* § 722. Section 722 applies the associate's cost basis in the assets to the partnership interest received in the exchange.

102. *Id.* § 723.

103. *Id.* §§ 1245(a), 1250(a).

104. *Id.*

1 McKEE, *supra* note 16, ¶ 5.03[1][d] suggests that special allocations of the partnership deduction, partnership gain or loss, and the partnership's basis increase may be desirable to assure fair tax results among the partners.

105. See Rev. Rul. 74-503, 1974-2 C.B. 117, which seems to indicate that a corporation has no basis in the issued stock. See also 1 McKEE, *supra* note 16, ¶ 5.03[1][c].

106. I.R.C. § 1032.

107. Treas. Reg. § 1.1032-1(a) (1960).

108. The transfer would still be characterized as a section 707(c) guaranteed payment for purposes of section 162(a). I.R.C. § 707(c); Treas. Reg. § 1.721-1(b)(2)(i) (1960). See also 1 McKEE, *supra* note 16, ¶ 5.03[1][c].

c. Recapture of Investment Credit by the Existing Partners

It is also necessary to consider the possibility that the associate's promotion will require the existing partners to recapture prior investment tax credit taken by the partnership. This situation differs from that in Situation I. Here, the investment credit property has been placed in service by the partnership (and not by the partner contributing the property) prior to the promotion of the associate to partner status. Section 1.47-6(a)(2)¹⁰⁹ of the regulations specifically provides that if, before the close of the estimated useful life used in computing the investment tax credit, a partner's profits interest or a partner's interest in specific section 38 property is reduced to less than two-thirds of that interest existing prior to the admission of the new partner, the section 38 property "ceases to be section 38 property with respect to such partner to the extent of the actual reduction in such partner's proportionate interest in the general profits of the partnership (or in the particular item of property)."¹¹⁰

The two existing equal partners would both fall short of the required retention of two-thirds of their profits interests if the associate was admitted as a full one-third partner. Their respective profits interests would have been reduced to .660 of their interests prior to the associate's admission ($.33/.50 = .660$), whereas the maximum reduction allowed would be to .667 of their prior interests.¹¹¹ Thus, the two existing partners would both be required to recapture some prior investment credit.¹¹²

In this situation it has been assumed that the associate receives an unrestricted interest in partnership capital in exchange for property and services. Such an interest would include a portion of the partnership's accounts receivable.¹¹³ The receipt of an interest in partnership accounts receivable requires additional consideration since many law partnerships may wish to allow a newly admitted partner an interest in partnership receivables only after the partner has demonstrated some capability. Hence, the third hypothetical situation follows.

109. Treas. Reg. § 1.47-6(a)(2) (1967).

110. *Id.* § 1.47-6(a)(2)(i)(b) & (ii) (1967).

111. *Id.*

112. *Id.* § 1.47-1(a)(1)(i) (1967). See generally 2 McKEE, *supra* note 16, ¶ 15.08[2]; 2 A. WILLIS, *supra* note 13, § 69.07.

113. See *Roberts Co.*, 5 T.C. 1 (1945). See also note 8 *supra*. The accounts receivable qualify as property for section 721 purposes and, as property rights, should be considered as part of the partnership capital. This is not to assert, however, that the receivables are capital assets, which, in this case, they clearly are not. I.R.C. § 1221(4).

C. Situation III: Admission of a New Partner—the Problem of Existing Receivables

In Situation III it is assumed that the arrangement in Situation II will be used to accomplish the admission of a new partner to the partnership. Additionally, it is assumed that the new partner's capital interest provides no interest in partnership receivables until she has been a partner for five years. Since the receivables in a law partnership will generally constitute a large portion of its capital, this will be an important and significant restriction upon the capital interest. As in Situation II, the new partner will receive a one-third interest in partnership profits generated after her admission.

1. *Defining the New Partner's Capital Interest*

At this point it is helpful to examine the composition of the new partner's capital interest. Since whatever interest she immediately receives in partnership capital will be taxable under section 61(a) as compensation for future services,¹¹⁴ its value and makeup must be ascertained. In Situation III it is assumed that the new partner receives an immediate interest in equipment, library, goodwill, cash, and other partnership property. She receives no interest in existing partnership receivables.

2. *Bifurcation of the Transaction*

The point at which the bifurcation of the interest (discussed in Situation II) occurs must also be noted. The bifurcated approach used in the *Frazell* decision requires that the partnership capital interest received in exchange for services be accounted for in a taxable transaction separate from the portion of the partnership capital interest received in exchange for section 721 nonrecognition property.¹¹⁵ Accordingly, to the extent that the value of the capital interest received exceeds the value of the contributed cash, it is taxed separately as compensation for services.¹¹⁶

3. *Treatment of the Bifurcated Transaction*

In addition to giving the new partner a right to partnership capital, there are several ways of giving her an interest in receivables. In Situation III, the new partner has no interest in the receivables upon admission to the partnership.

114. See notes 61-77 & accompanying text *supra*.

115. *United States v. Frazell*, 335 F.2d 487, 490 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965).

116. *Id.*

a. *Tax Consequences of a Promise of a Future Capital Interest*

(1) *Receipt of the Promise*

Where a promise is given, the new partner has actually received nothing of value for tax purposes, but has merely been promised an interest in the receivables at a point in time five years hence. Thus, the analysis of the taxable portion of this bifurcated transaction would be similar to that made in Situation II.¹¹⁷ In addition, the tax consequences to the partnership would be similar to those discussed in Situation II.¹¹⁸ The problem in Situation II of whether to use a one or two step approach in the analysis of the taxable portion of the transaction would arise here also.¹¹⁹

(2) *Receipt of the Promised Capital Interest*

Five years hence, having performed to everyone's expectations, the new partner would receive a full one-third capital interest in the partnership receivables. The interest would be characterized as compensation for services and would be taxable under section 61(a)¹²⁰ to the extent of its fair market value.¹²¹ The receipt of the interest in receivables would yield tax consequences identical to those in Situation II with respect to the taxable (compensation for services) portion of the contribution transaction.¹²²

b. *Restricted Transfer of Property for Services—Section 83(a)*

An alternative method for granting the new partner an interest in partnership receivables is to give her a present interest in them subject to forfeiture if she ceased to be a partner within five years. This method assumes that the new partner immediately receives an interest in receivables generated through the efforts of the existing partners prior to her entry. Thus, upon realization of those receivables by the partnership, the new partner would be taxed on her distributive share of partnership income, as determined according to her profits interest.¹²³ If she were to relinquish her status as a partner within five years, she would forfeit any interest in the receivables. Thus, neither her rights in partnership capital nor

117. See notes 78-104 & accompanying text *supra*.

118. See notes 86-104 & accompanying text *supra*.

119. *Id.*

120. Treas. Reg. § 1.721-1(b)(1) (1960). See also notes 61-77 & accompanying text *supra*.

121. Treas. Reg. § 1.721-1(b)(1) (1960).

122. See notes 78-104 & accompanying text *supra*.

123. I.R.C. § 702(a).

the value of her partnership interest would be determined with reference to the existing receivables.

Although the restricted transfer method outlined above is less likely to occur in a law partnership context than the promise of a future transfer, or an unrestricted present transfer of such an interest, the approach does merit some discussion.

(1) Valuation and Inclusion—Timing

Under section 83,¹²⁴ the transaction will be treated as a restricted transfer of property in connection with the performance of services.¹²⁵ That portion of the new partner's capital interest attributable to her restricted interest in receivables will be taxed under section 83 which provides for the timing of two important events: (1) the valuation of the interest received and (2) the inclusion of that amount in the recipient's income. Under section 83, the valuation of the interest and its inclusion in income must occur at the time the property becomes either transferable or not subject to a substantial risk of forfeiture.¹²⁶ Thus, at the end of the five year period, the new partner will be required to recognize as ordinary income the amount by which the fair market value of her interest in unrealized receivables exceeds the amount she paid for it.

(2) Holding Period for the Interest in Receivables

Under section 83(f),¹²⁷ the new partner's holding period for the portion of her capital interest attributable to receivables begins only when that interest is no longer subject to a substantial risk of forfeiture. This result is somewhat troublesome since a partnership interest is generally not fragmented for holding period purposes.¹²⁸ In this situation it is necessary to fragment the new partner's partnership interest into separate entities to determine its holding period. Thus, the question arises whether this fragmentation would apply to sales or distributions of any portion of the total (restricted as well as unrestricted) partnership interest or whether only the holding period of the restricted portion of the capital interest would be determined under section 83(f).¹²⁹

124. *Id.* § 83.

125. *Id.* § 83(i).

126. *Id.* § 83(a).

127. *Id.* § 83(f).

128. See note 50 & accompanying text *supra*.

129. See 1 A. WILLIS, *supra* note 18, § 13.07.

(3) *Other Consequences of Applying Section 83 to the Transaction*

(a) *The Partnership Deduction*

If the new partner receives a capital interest in exchange for services in a transaction to which section 83 applies, some other tax consequences should be considered. There is a provision under section 83 which allows the transferor-partnership to take a deduction for the payment, if allowable under section 162 or 212.¹³⁰ The amount of the deduction is limited to the amount included in the new partner's gross income under section 83(a), (b), or (d)(2).¹³¹ The deduction must be taken for the taxable year in which that amount is included in the new partner's gross income.¹³² The result is that the amount of the deduction is determined under section 83, whereas its deductibility is determined under sections 162 and 212.¹³³

(b) *Recognition of Gain by the Partnership*

Another possible consequence of the application of section 83 to this transaction is that upon the transfer of the restricted capital interest, the transferor-partnership must recognize as gain the amount by which the value received from the new partner exceeds the partnership's basis in the transferred property.¹³⁴ Also, at the time the restrictions on the new partner's interest lapse and the partnership is allowed its deduction under section 83(h), the partnership must recognize gain or loss to the "extent of the difference between (i) the amount allowed as a deduction under section 83(h), and (ii) the sum of the taxpayer's basis in the property plus any amount recognized pursuant to the previous sentence."¹³⁵ The effect of this provision is the synchronization of the timing of all tax consequences of receiving a compensatory partnership capital shift subject to a substantial risk of forfeiture.

The wording of regulation § 1.83-6(b)¹³⁶ purports to treat Situation III as one transaction. It seems to include all amounts the partnership receives from the new partner as part of the compensable transfer, and therefore, to require recognition of gain by the partnership to the extent that it receives property or services in

130. I.R.C. § 83(h).

131. *Id.*

132. *Id.* If the taxable years of the new partner and the partnership do not coincide, the deduction must be taken for the partnership taxable year in which the new partner's taxable year ends. *Id.*

133. Treas. Reg. § 1.83-6(a)(1) (1978).

134. *Id.* § 1.83-6(b).

135. *Id.*

136. *Id.*

excess of the transferor's basis in the property received by the partnership. This treatment will have no effect on Situation III unless the money and other property contributed by the new partner in fulfillment of her initial commitment exceeds the partnership's basis in the transferred partnership interest.

In any event, the *Frazell* decision indicates that nonrecognition treatment under section 721 is appropriate for that portion of the transaction attributable to the new partner's contribution of money and section 721 property. Thus, the partnership would not recognize gain upon the initial transfer of the interest. This bifurcated approach also results in the remainder of the transfer being treated separately under section 83 and regulation 1.83-6(b). Even though proposed regulation 1.721-1(b)(2) (1971) indicates that section 83 applies to this type of transaction, it does not seem to preclude nonrecognition treatment of the portion of the partnership interest received in exchange for section 721 property.¹³⁷

c. *The Section 83(b) Election Approach*

A third method of granting the new partner an interest in partnership receivables involves an election, under section 83(b),¹³⁸ to tax the transaction upon her admission to the partnership (as opposed to waiting until the restrictions lapse). If this is done, her partnership interest is valued at the time of the transfer.¹³⁹ The section 83(b) election must be made within 30 days of the transfer.¹⁴⁰

When the section 83(b) election is made, the new partner's holding period with respect to the transferred property begins "just after the date such property is transferred."¹⁴¹ The partner-

137. There are additional consequences of the application of section 83 involving Treas. Reg. § 1.83-1(a)(1)(ii) (1978), which states:

[U]ntil such property becomes substantially vested, the transferor shall be regarded as the owner of such property, and any income from such property received by the employee or independent contractor . . . or the right to the use of such property by the employee or independent contractor constitutes additional compensation and shall be included in the gross income of such employee or independent contractor for the taxable year in which such income is received or such use is made available.

Id.

138. I.R.C. § 83(b).

139. *Id.* § 83(b)(1).

140. *Id.* § 83(b)(2); Treas. Reg. 1.83-2 (1978). The section 83(b) election seems to pose a risk that by the time the restrictions on the property lapse, its value will have decreased substantially. This would result in the recipient having been taxed on value which is never realized. See *id.* § 1.83-2 (1978). There is an additional risk that a refund claim will be barred by the statute of limitations by the time the restrictions lapse.

141. *Id.* § 1.83-4(a) (1978).

ship's corresponding deduction would be taken in the year the amount is included in the new partner's income unless the partnership's tax year differs from the new partner's tax year.¹⁴² The recognition of gain by the partnership would also occur at the time of the transfer.¹⁴³

d. Recapture of Investment Credit

The investment credit recapture consequences to the existing partners were considered under Situation II and are similar here.¹⁴⁴

D. Situation IV: Annual Shifts of the Partners' Capital Interests

In Situation IV, it is assumed that a partnership, consisting of two equal partners, decides to admit a new partner for a smaller share of partnership capital and profits than in the previous situations. However, the partnership will increase the new partner's interests annually for five years, at which time she will have attained a full one-third interest in both profits and capital.

1. Tax Consequences of Receiving Annual Capital Shifts

In this situation, the annual shifts of capital interests, by which the existing partners relinquish their rights in partnership capital, will be taxable transactions. This is due to the fact that these transfers are nondonative in nature. Regulation 1.721-1(b) provides:

To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services . . . section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.¹⁴⁵

Thus, the taxability of the transaction results from the explicit nonapplicability of section 721.

The tax consequences of the transaction involve recognition of ordinary income by the new partner to the extent of the fair market value of the capital interest received.¹⁴⁶ The bifurcated holding period problem occurs in this situation as in Situation III.¹⁴⁷ However, this situation seems sufficiently analogous to the midstream contribution of capital by an existing partner to preclude bifurca-

142. *Id.* § 1.83-6(a)(1).

143. *Id.* § 1.83-6(b).

144. See notes 109-112 & accompanying text *supra*.

145. Treas. Reg. § 1.721-1(b)(1) (1960).

146. *Id.*

147. See notes 50-84 & accompanying text *supra*.

tion of the new partner's partnership interest into different segments based upon their respective holding periods.¹⁴⁸ The new partner's basis in her partnership interest will equal the amount of gain she recognizes upon its receipt plus any additional liabilities that she assumes as a result of the increased capital interest.¹⁴⁹

2. Tax Consequences to the Partnership

The treatment of the partnership will be similar to its treatment in the analysis under Situation II.¹⁵⁰ Additionally, the existing partners are relieved of liabilities to the extent they are assumed by the new partner when she receives her capital interest.¹⁵¹ This relief of liabilities is treated as a distribution of cash to the existing partners under section 752(b).¹⁵²

The investment credit recapture computation would have to be made with every shift of partners' profits interests in this situation.¹⁵³ Thus, at the point when the existing partners' profits interests or interests in specific section 38 property are reduced below the applicable amount,¹⁵⁴ they will be required to recapture some or all of their prior investment credit.¹⁵⁵ The timing of the recapture is determined by the extent of reduction in the profits interest of the existing partners.¹⁵⁶

148. Cf. Allan S. Lehman, 7 T.C. 1088 (1946), *aff'd*, 165 F.2d 383 (2d Cir. 1948) (rejecting the Commissioner's claim that the holding period of the partnership assets instead of that of the partnership interest determines the long- or short-term nature of the gain or loss resulting from a sale of a portion of the partnership interest). See note 50 *supra*.

149. Treas. Reg. § 1.722-1 (1960).

150. See notes 85-112 & accompanying text *supra*.

151. Treas. Reg. § 1.752-1(e) (1960) provides that "[a] partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement." Unless otherwise stated, this comment has assumed, throughout, that partnership profits, losses, and capital have been shared equally according to each partner's respective percentage share of capital.

152. I.R.C. § 752(b); Treas. Reg. § 1.752-1(b)(1) & (2) (1960). See note 20 *supra*.

153. With each shift of capital the existing partners would be reducing their interest in partnership capital and profits. Thus, Treas. Reg. § 1.47-6(a)(2)(i)(b) (1967) would apply to each shift to the extent that the partners' profits interests or interests in section 38 property are reduced below two-thirds of those interests prior to admission of the new partner.

154. *Id.* § 1.47-6(a)(2)(ii) (1967) states that the applicable percentage "is 66⅔ percent of the partner's proportionate interest in the general profits of the partnership (or in the particular item of property) for the year in which such property was placed in service." After property has been treated under the sentence quoted above as having ceased to be section 38 property, the applicable percentage for further reductions is 33⅓ percent of the partner's interest in the year the property was placed in service. *Id.*

155. I.R.C. § 47(a)(1).

156. Treas. Reg. § 1.47-6(a)(2)(i)(b) (1967).

E. Situation V: The Profits Interests in Situations I-IV

Situation V is a brief analysis of the federal income tax consequences of the receipt of a profits interest in a law partnership in exchange for services and a brief comment on the alternative approaches to the tax treatment of such interests.

Generally, the previous situations have ignored the ominous *Sol Diamond*¹⁵⁷ decision and assumed that the receipt of a profits interest in a law partnership is not a taxable event.¹⁵⁸ Unless stated otherwise, it has also assumed that profits have been allocated in the same proportions as the partners' respective capital

157. 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).

158. For analysis of the *Diamond* case and of the issue of the taxability of the receipt of a profits interest in exchange for services, see generally 1 McKEE, note 16 *supra*, ¶ 5.05-.08; 1 A. WILLIS, note 18 *supra*, at 99-137; Cowan, *Receipt of an Interest in Profits in Consideration for Services: The Diamond Case*, 27 TAX. L. REV. 161 (1972); Lane, *Sol Diamond: The Tax Court Upsets the Service Partner*, 46 S. CAL. L. REV. 239 (1973).

ALI FEDERAL INCOME TAX PROJECT: SUBCHAPTER K—PROPOSALS FOR CHANGES IN THE RULES FOR TAXATION OF PARTNERS (Tentative Draft No. 3, March 27, 1979), contains a helpful discussion of the area at pp. 77-94. Proposal D2(A) recommends that "[e]xcept as provided in Paragraph (B) below, the fair market value of an interest in partnership profits received in exchange for performing services for such partnership shall not be included in the recipient's income." *Id.* at 95. An exception to that general rule is recommended in Proposal D2(B) as follows: "If a profits interest in a partnership is received in exchange for services which are not performed, either for the partnership or in connection with property contributed to the partnership, the fair market value of such interest shall be included in the recipient's income." *Id.* Proposal D3(B) defines an interest in partnership profits as an interest which "is not an interest in partnership capital." *Id.*

One other important exception to the general rule of not taxing the receipt of profits interests is recommended. Proposal 5A states:

[i]f a profits interest in a partnership is received for services (other than services described in D2B above), and during any taxable year of the partner ending less than 3 years after he receives such interest, all four of the factors listed in Paragraph (B) are present, any distribution from the partnership to the recipient of such interest during any period when all four factors exist, will be treated as a guaranteed payment for services under § 707(c).

Id. at 99. The factors which must exist are:

- (i) the partnership is one in which capital is a material income-producing factor;
- (ii) the person receiving a profits interest has not contributed capital to the partnership (or assumed liability for indebtedness) in proportion to his interest;
- (iii) the person receiving the profits interest has less than a [10%] interest in the partnership; and
- (iv) less than [50%] in interest of the partnership is owned by service partners described in (iii).

Id. In an attempt to clarify this area, these proposals support the conclusion that the receipt of a profits interest in a law partnership in Situations I-IV would not be a taxable transaction.

interests.¹⁵⁹ This was done for several reasons.

An interest in partnership profits is likely not to have value in and of itself since, unlike the situation in *Diamond*, a law partnership is a service partnership, the income from which is totally dependent upon the future performance of services by the partners. In contrast, the partner in *Diamond* received a capital interest in a partnership exchange for services rendered prior to formation of the partnership. Similarly, the profits interest in a law partnership is an ordinary income interest since it is compensation for services; thus, the application of section 83¹⁶⁰ to the receipt of a profits interest in a law partnership would be needlessly repetitive, as section 61 already applies to the transaction.

It also appears that any value in the partnership interest not attributable to the partnership capital and the future performance of services should be attributable to partnership accounts receivable. One commentator has characterized an interest in partnership receivables as a profits interest.¹⁶¹ This comment has taken the position that receivables are partnership capital and that to the extent one receives an interest in partnership unrealized receivables, he has received an interest in partnership capital in exchange for future services which is, quite properly, immediately taxable to the recipient under section 61 unless substantially restricted or subject to a risk of forfeiture.¹⁶²

Also, the profits interest is rightfully taxed to the partner when ordinary income attributable to his or her distributive share of partnership income is realized.¹⁶³ Thus, postponement of the vesting of ownership under section 83 due to substantial forfeiture risks, i.e., failure to perform future services, would serve only to complicate the analysis of the transaction in order to achieve a result already attainable under section 61.

Finally, it would appear that the *Diamond* case merely taxed the transferor of an interest in property which had substantially appreciated in value. Whether or not that interest is termed an interest in capital or profits, it is a type of appreciated interest

159. Thus, a partner having a one-third capital interest would also have a one-third share of profits.

160. I.R.C. § 83 would seem to apply to any interest where a partner was required to perform future services in order to realize the benefits of the interest. Treas. Reg. § 1.83-3(c)(1) & (2) (1978).

161. 2 A. WILLIS, *supra* note 18, § 51.04.

162. Section 83 would apply to those situations under Prop. Reg. § 1.721-1(b)(1)(i) (1971).

163. This assumes that the income generated by the partnership will be ordinary in character. This should hold true in most law partnerships where the income is generated from services.

which will not likely be present in a service partnership except with respect to the partnership capital.

It should be noted that if partnership unrealized receivables are treated as profits rather than capital, the transactions may fall under section 83 since the receipt of income from the profits interest is generally forfeited if the transferee fails to perform services.¹⁶⁴ Section 83 postpones the vesting of the interest for federal tax purposes, resulting in the possible denial of partner status to the transferee.¹⁶⁵ If that result obtains, then all income received by the transferee (the quasi-partner) would be characterized as compensation and would be ordinary in nature.¹⁶⁶

Similarly, if receipt of the profits interest is not taxed under section 83 but is subjected to an open transaction analysis,¹⁶⁷ it seems that the same income characterization problem would result. However, it does not seem necessary to apply either of these approaches to the transfer of typical profits interests in law partnerships.

III. CONCLUSION

The nature of a partnership—whether it is a capital intensive or service partnership—may significantly affect the incidents of an ownership interest in partnership capital, as opposed to a profits interest. It is the service nature of a law partnership which leads to the emphasis on the allocation and distribution of profits interests while the partner's capital interests, *i.e.*, their interests in specific partnership property or their rights to such property upon liquidation, withdrawal or retirement, are perhaps under-emphasized.

Because the application of the technical rules of subchapter K and other relevant Code provisions may result in adverse tax consequences to the partners in the specific transactions analyzed, serious consideration should be, and often is, given to the separation of a partner's interest in capital profits. Thus, a partner's interest should not be limited in description to "a one-third interest" in a law partnership. The partners' interests in partnership capital should be stated separately from their profits interests. The dis-

164. Many investment or other types of partnerships may not require substantial services from service partners and section 83 would not treat such partners as holders of restricted interests. Treas. Reg. § 1.83-3(c)(1) & (2) (1978). A law partnership would most likely require the performance of substantial services in this situation.

165. "Until such property becomes substantially vested, the transferor shall be regarded as the owner of such property" *Id.* § 1.83-1(a)(1) (1978).

166. *Id.*

167. *See, e.g.*, *Burnet v. Logan*, 283 U.S. 404 (1931).

tinctive tax consequences attributable to the differing natures of these interests can thereby be given appropriate consideration.

Many law firms will not require a partner to buy an interest in the partnership which is based on the fair market value of the tangible and intangible assets. The valuation and bifurcation problems which accompany the receipt of a capital interest which is, in part, received in exchange for past or future services may be extensive. Thus, where each partner is required to buy a partnership capital interest, for instance, by paying \$5,000 into a capital account, that amount can be separately accounted for and would facilitate future shifts in the profits interests without the otherwise burdensome consequences which flow from the manipulation of the capital interests.

Through the use of a fixed, static capital account, the amount received by a partner upon termination or withdrawal could be taxed pursuant to section 736(b) while the amount received in the form of section 707(c) guaranteed payments could be derived from the partner's profits interest. The separation of the capital and profits interests and the limitation on the manipulation of the capital account provide an emphasis on the profits interests, and their allocation, which is consistent with the significant role of the profits interests in the service partnership.

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